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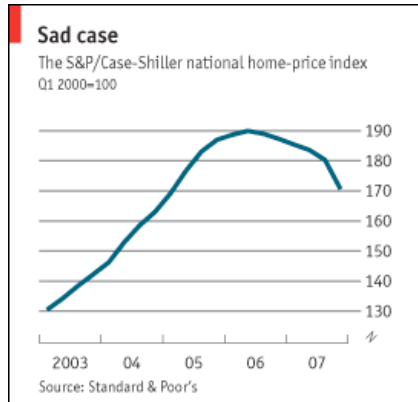
Feb 28th 2008 | WASHINGTON, DC
 From *The Economist* print edition

As America's mortgage mess worsens, radical solutions are gaining appeal



WITH brick-fronted townhouses and old-fashioned street lamps, Faulkner's Landing in Ashburn is one of hundreds of new developments that sprouted across the farmlands of northern Virginia during America's housing boom. Less than three years old, these houses originally sold for around \$550,000, but are now worth some 40% less than that. Foreclosures are rising. For owners who put little or no money down, points out Danilo Bogdanovic, a local estate agent, it is often not worth paying a mortgage far greater than the value of the house.

As America's house prices slide, fears are growing that more people will post the keys to their lender and walk away. The practice, already common among speculative buyers, has a nickname, "jingle mail". For a fee, websites such as youwalkaway.com, explain what to do. Laws on repossession differ by state. But thanks to high legal costs, mortgage firms have historically not chased borrowers even when the law allows it.



It is easy to paint grim scenarios. Repossessions are soaring, up 90% from a year ago according to RealtyTrac, a seller of foreclosure statistics. According to the S&P Case-Shiller index, average house prices fell by 9% in 2007 (see chart), and the pace of decline is accelerating. Mark Zandi of Moody's Economy.com reckons that 8.8m mortgage-holders, 17% of the total, have home loans that are greater than the value of the house. If house prices fall by another 10%, as he expects, Mr Zandi expects almost 14m mortgages to be underwater in a year's time.

Given that the typical mortgage is worth \$225,000, over \$3 trillion of debt would

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be affected. Since the costs of foreclosure can eat up 25% or more of the value of a loan, the losses could be enormous if a large fraction of these borrowers walk away. Nouriel Roubini, one of Wall Street's most pessimistic seers, worries that the "forthcoming jingle-mail tsunami" could spawn \$1 trillion-2 trillion of financial losses, creating a systemic banking crisis.

Experience from previous regional housing busts suggests most people with negative equity do not simply walk away from their houses. But much about today's situation is unprecedented—particularly the high initial loan-to-value ratios. On February 27th Fannie Mae, the government-backed mortgage giant, announced an unexpectedly big loss of \$3.55 billion for the fourth quarter of 2007 because of increased foreclosures.

Until recently, Washington's main fear was that foreclosures would soar as the low initial interest rates on some 2m adjustable subprime mortgages reset. In December 2007, to great fanfare, the Bush Treasury cajoled the mortgage industry into promising a (voluntary) temporary rate-freeze for certain groups of borrowers. So far, these efforts have yielded little. But thanks to big rate cuts by the Federal Reserve, resets are becoming less of a problem. One analysis suggests that the typical reset now involves a jump in monthly payments of just over 10%, compared with 25-30% six months ago.

But even as resets become less painful, analysts are realising that they are not the main cause of foreclosure. An influential study from the Federal Reserve Bank of Boston points to falling house prices, and the resultant negative equity, as a far bigger trigger. Stemming foreclosures, points out Paul Willen, an author of the study, will depend on reducing the size of mortgages relative to the value of a house.

One approach under consideration in Congress is to adjust America's personal-bankruptcy law so that judges can "cram down" a mortgage to the market value of a house. Under current law, judges cannot reduce the debt on someone's main residence, though they can do so for holiday homes or investment properties. Proponents of the legislation reckon 600,000 people could avoid foreclosure if the rules were changed.

The Economist's house-price indicators

% change

	Latest	Q4 2006	1997-2007
Singapore	31.2	10.2	na
Hong Kong	24.3	3.6	-29
Australia	12.3	9.7	168
Belgium	11.4	9.3	142
Sweden	11.3	10.5	149
China	10.5	5.3	na
South Africa	9.1	14.8	395
New Zealand	8.9	9.2	124
Canada	6.0	11.5	80
France	5.6	9.9	150
Italy	5.1	6.2	102
Spain	4.8	9.1	190
Britain	4.2	9.4	210
Netherlands	3.8	4.7	102
Denmark	2.1	14.9	129
Switzerland	2.0	1.8	19
United States (OFHEO)	0.8	5.9	94
Japan	-0.7	-2.8	-32
Germany	-2.7	-1.1	na

The mortgage industry is vehemently opposed. And many economists worry that allowing cram-downs will worsen the drought of credit in America's mortgage markets. Chris Mayer of Columbia Business School points out that some \$750 billion of annual mortgage lending has dried up as the securitisation of subprime and jumbo loans has collapsed. Changing bankruptcy rules, he argues, would make matters worse by raising the cost and reducing the supply of mortgage credit. Several studies have shown that borrower-friendly laws lead to more restricted credit. However, a new paper by Adam Levitin of Georgetown University Law School and Joshua Goodman of Columbia University finds scant difference in interest rates on mortgages that can already be crammed down (such as holiday homes) and those that cannot.

Unsurprisingly, bankers are lobbying for a different approach, one where the government stems the foreclosure spiral (and limits losses) by buying and

Ireland	-7.3	13.1	227
United States (Case-Shiller national index)	-8.9	0.2	104
United States (Case-Shiller ten-city index)	-9.8	8.7	156

Sources: ABSA; ESRI; Hypoport; Japan Real Estate Institute; Nationwide; Nomisma; NVM; OFHEO; Quotable Value; Stadim; Swiss National Bank; Standard & Poor's; government offices

refinancing whole swathes of mortgages. One idea, championed by Chris Dodd, the chairman of the Senate Banking Committee, is to recreate a modern version of the Home Owners' Loan Corporation, a Depression-era institution that refinanced mortgages in the mid-1930s when almost half of all home loans were in default. Other proposals

have similar aims. A government institution, such as the Federal Housing Administration (FHA), would buy mortgages at a discount and refinance them into new loans with a government guarantee. Credit risk for the refinanced mortgages would shift to Uncle Sam.

How much of a "bail-out" this implies depends on the discount at which the mortgages are bought and on their subsequent performance. Most proposals suggest using the market price; Mr Zandi wants the government to buy mortgages by auction. Some plans are ambitious: Alan Blinder of Princeton University foresees an institution that takes over between 1m and 2m loans, worth \$200 billion-\$400 billion. Other schemes are narrower. Democratic congressmen talk of an initial capitalisation of around \$20 billion.

Another complementary idea, touted by the Office of Thrift Supervision (OTS), is to give mortgage lenders a share of the upside if properties appreciate. Under this scheme, the FHA would insure a new mortgage at a house's current value. The existing lender would get a "negative equity" claim for the difference between that and the original loan, which could be exercised if the house later sold at a higher price. Some proponents of bankruptcy reform want to attach similar provisions to the cram-down. But the details of any "shared appreciation" devices are tricky. If homeowners have little hope of building equity in their house, the incentive to default remains.

All told, all the plans are fraught with problems. Bankruptcy reform will help some of today's borrowers while hurting tomorrow's. Government refinancing potentially puts taxpayers' money at risk. For the moment, the Bush administration opposes both and pins its hopes on voluntary loan modifications. Public opinion is also against any "bail-out". But the climate in Congress is shifting. As the housing market worsens, bigger government intervention is becoming ever more likely.

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